WHY SAVING BEYOND PENSION TAX RELIEF LIMITS MIGHT NOT BE A BAD IDEA

Good with your Money Guide 9

INTRODUCTION – pension tax relief and the limits on pension tax relief

One of the big attractions of paying money into a pension is that in most cases you qualify for tax relief on those contributions. In simple terms, this means that money that goes into a pension is deducted from your income before your tax is worked out, thereby lowering your tax bill.

For example, if you put £100 into a pension out of your pre-tax income and pay tax at the standard rate of 20%, your tax bill falls by £20 and the net cost to you of putting £100 in a pension is reduced to £80. Similarly, if you pay tax at 40%, it only costs you £60 to put £100 in a pension, and if you pay tax at 45%, it only costs you £55.

When you finally start to draw your pension, pension withdrawals are generally taxable, but in many pension arrangements, 25% of your pension pot can be taken tax free. In addition, most higher earners who get tax relief at 40% or more during their working life may only pay income tax at 20% in retirement. Similarly, some lower earners may pay the standard rate of income tax at 20% during their working life but have too little income to pay any tax at all any retirement.

[1] In some schemes contribute to your pension from your pre-tax income and the cost is partly offset by a lower tax bill. In other schemes you contribute out of your take-home pay and the tax bill saving is added by HMRC to your pension fund. In most cases however the net effect is the same.

[2] The same basic principles apply in Scotland, although there are more income tax rates and the method by which tax relief is delivered has been slightly altered to reflect this.

For all of these reasons, tax relief on pension contributions is seen as a very attractive benefit. As a result, successive governments have decided to limit these tax benefits. There is both an annual limit on pension savings which qualify for tax relief and a lifetime limit on the total pot which can be built up with the benefit of tax relief. Both of these limits have been tightened significantly in recent years. Before the limits were lowered they were probably only the concern of the most wealthy, but growing numbers of people are having to be aware of tax relief limits, including those who may not think of themselves as rich but who perhaps have long service in a salary-related pension scheme.

It might reasonably be assumed that once you have reached your annual or lifetime limit for pension tax relief you should – or even must – stop putting money into a pension.

The purpose of this guide is to demonstrate that this is not necessarily the case.

It is not unlawful or immoral to save into a pension beyond the limit for pension tax relief. You simply need to be aware of the tax consequences of doing so. And because there are other attractive features of pensions – notably the potential for a large contribution from your employer – this paper explains that opting out of your pension may leave you worse off financially than if you stay in, even allowing for any resultant tax charges.

We stress throughout this paper that these are complex issues. Anyone worrying about having a pension pot worth over a million pounds or considering contributing tens of thousands of pounds a year to their pension should think seriously about paying for the services of an impartial financial adviser who can go through their individual situation and advise them how best to proceed. But we hope that this paper will make you aware of the issues and will ensure that people do not make themselves worse off by opting out unnecessarily from their pension scheme.

1. How Annual and Lifetime Allowances work

a) Annual Allowance (AA)

In simple terms, the Annual Allowance (AA) is the limit to the amount of money that can go into your pension each year whilst still benefiting from pension tax relief. There are two main elements to this:

- The money that you and your employer have put in to a Defined Contribution or 'pot of money' pension arrangement;
- The value of the increase in rights you may have under a Defined Benefit or salary-related pension; there are complex rules as to how this is worked out, but essentially, the growth in your annual pension (beyond simply keeping pace with inflation) is multiplied by 16, and this is the amount of your AA you have used up; your annual pension statement from your DB pension scheme should give you this figure;

The current rate of the AA is £40,000, but as Table 1 shows, the limit has fallen significantly in recent years.

Table 1. Rates of Annual Allowance since 2010/11

Tax year	Amount
2019/20	£40,000
2018/19	£40,000
2017/18	£40,000
2016/17	£40,000
2015/16	6 April 2015 to 8 July 2015 – £80,000 9 July 2015 to 5 April 2016 – £0
2014/15	£40,000
2013/14	£50,000
2012/13	£50,000
2011/12	£50,000
2010/11	£255,000

Source: gov.uk

1. How Annual and Lifetime Allowances work

When might I be able to contribute more or less than the standard Annual Allowance?

There are three main situations in which your personal limit for a financial year might be different to the standard figure shown in Table 1. These are as follows:

a) The 'tapered' Annual Allowance

Since 2016/17, the highest earners have faced a further limit on the amount that they can contribute into a pension each year whilst benefiting from tax relief. This is known as the 'tapered' Annual Allowance. In simple terms, this affects those with more than £150,000 per year of total taxable income (including all sources of taxable income and also including the value of any employer pension contributions). For every £2 of taxable income above the £150,000 threshold, their Annual Allowance is reduced by £1. For those with £210,000 per year or more of total income, the AA is reduced to a floor of £10,000.

b) The 'Money Purchase Annual Allowance' (MPAA)

The Money Purchase Annual Allowance (MPAA) was introduced in April 2015 and applies where the scheme member has started to take money out of a Defined Contribution pension (beyond any tax-free amount) but may still be contributing into a pension.

For example, someone who is made redundant in later life might use the new 'pension freedoms' to access their pension fund post 55 in order to support their daily living costs but then might get another job and start building up pension savings again. Once they have accessed their pension pot and started taking chunks of taxable cash, their future Annual Allowance for contributions into pension saving is capped by the MPAA.

The level of the MPAA is £4,000 and applies not only to contributions by the member to a DC scheme but also any contributions made by the employer. The test of DC contributions against the MPAA is in addition to the test of total pension saving during the year against the Annual Allowance.

c) Carry Forward

The ability to 'carry forward' unused Annual Allowance from earlier years can enable you to put more into your pension than the standard Annual Allowance.

In simple terms, if you have unused Annual Allowances from any of the three previous financial years you can bring those unused allowances forward and add them to your standard or tapered Annual Allowance limit for the current year. A financial adviser would be able to talk you through the benefits of taking advantage of unused allowances from previous years before the opportunity to do so expires.

b) Lifetime Allowance (LTA)

The Lifetime Allowance (LTA) is the limit on the amount of pension you can build up during your working life whilst benefiting from pension tax relief. In simple terms, what is being counted is:

- The total amount of money you hold in Defined Contribution or 'pot of money' pensions; plus
- The annual value of Defined Benefit or salary-related pensions multiplied by a factor of 20;

[3] There are further rules about who is affected by this tapering, and these can be found at https://www.gov.uk/tax-on-your-private-pension/annual-allowance

1. How Annual and Lifetime Allowances work

The test of whether you have exceeded your Lifetime Allowance charge is done every time you access your pension benefits. For example, this could be when you retire and start drawing a salary-related pension or when you take money out of a Defined Contribution pot and take tax-free cash, go into drawdown or buy an annuity.

The level of the LTA is shown in Table 2. As Table 2 shows, after a series of cuts in the earlier part of this decade, the limit was then frozen and is now being increased in line with inflation. Although this is the current policy, there is no guarantee that this limit will continue to increase.

Protecting a higher Lifetime Allowance

The Lifetime Allowance (LTA) is the limit on the amount of pension you can build up during your working life whilst benefiting from pension tax relief. In simple terms, what is being counted is:

As Table 2 shows, the LTA used to be much higher. Each time the LTA is cut there will be people who had been planning on the basis of the higher figure who will now have to change their plans and people whose pension pot was below the old LTA but above the new LTA who could face particular problems. In response to this, the government has allowed people to apply for a series of transitional protections each time the LTA was cut. These are highly complex but come in two main forms:

a) *"Fixed Protection"* – broadly speaking, this allowed people to fix their own LTA at £1.8m (for applications before 5th April 2012), £1.5m (for applications before 5th April 2014) or £1.25m (no deadline) on condition that they make no further pension contributions;

b) *"Individual Protection"* – Individual Protection gives individuals who think that the value of their benefits will be over the Lifetime Allowance when they come to take their benefits, a personalised Lifetime Allowance based on the value of their pension savings. The current version of Individual Protection (IP2016) allows individuals to have their own LTA set at the lower of £1.25m or the value of their pension savings as at 5th April 2016.

Again, taking financial advice on using LTA protections can be hugely valuable and help savers (and in some cases their bereaved family) to avoid large tax bills through exceeding lifetime limits.

Table 2. Rates of the Lifetime Allowance (LTA)

Tax year	Amount
2019/20	£1,054,000
2018/19	£1,030,000
2017/18	£1,000,000
2016/17	£1,000,000
2015/16	£1,250,000
2014/15	£1,250,000
2013/14	£1,500,000
2012/13	£1,500,000
2011/12	£1,800,000

Source: gov.uk

[4] This is known in the jargon as a 'Benefit Crystallisation Event'

2. What do I have to pay if I exceed my Annual or Lifetime Allowance?

While no-one wants to be hit with a charge for breaching the Annual or Lifetime Allowance it is really important to point out that these charges are not penalties for bad behaviour – you haven't broken the law by getting this penalty – it is simply a way for HMRC to claw back any excess tax relief you may have enjoyed by breaching these limits.

a) Tax charges for exceeding your Annual Allowance

If, having exhausted all available carry forward, the value of pension savings in any particular tax year exceeds your Annual Allowance then you will need to pay a tax charge on the amount of pension saving in excess of the limit. This excess is charged at your marginal rate of income tax. You will need to account for this on your self-assessment tax form.

Help with paying tax charges – getting your scheme to pay the bill

Sometimes, you may exceed your Annual Allowance without realising it or without necessarily having a lot of disposable cash. For example, by working an extra year in a salary-related pension arrangement you are adding to your pension wealth. If you are relatively well paid and in a generous pension arrangement, the increase in value of your pension wealth during the year can be more than your Annual Allowance, so you will get a tax bill. But you may not necessarily have hundreds or thousands of pounds available to pay the tax bill.

To prevent financial hardship, you can – subject to some conditions – ask your scheme to pay some or all of the charge on your behalf in return for a corresponding reduction in benefits.

Both of the following conditions must be met before your pension scheme is required to pay the charge:

- The AA tax charge for the member for the tax year across all pension schemes is greater than £2,000 AND
- The increase in the value of your pension rights in the scheme the charge is to be taken from is greater than £40,000.

These conditions continue to apply if the individual is subject to the MPAA or if their Annual Allowance is tapered due to higher earnings. This means that there are some people who could face a large tax bill but not qualify automatically for 'scheme pays'. For example, if your tapered Annual Allowance is £25,000 rather than the full £40,000, and your accrual in your salary-related scheme is £30,000, you will face a tax bill but do not have a right to access 'scheme pays' because you have not built up more than £40,000 in that scheme. Having said that, some schemes will offer to operate 'scheme pays' on a discretionary basis, so it is worth inquiring.

2. What do I have to pay if I exceed my Annual or Lifetime Allowance?

If you have a DC scheme and have to pay a tax charge then your fund value will be reduced by an amount equal to the tax charge – this includes any early withdrawal charges that might apply. If you have a DB or cash balance scheme then an adjustment will be made either to your prospective benefit rights, or to both your and your contingent beneficiaries' prospective rights. The law dictates that any adjustments made need to be "just and reasonable."

What are some of the potential advantages of getting your scheme to pay the tax charge?

- **Tax Relief** – Paying the charge from your own funds means the charge is paid from post-tax income. Using "scheme pays" has the benefit of allowing the charge to be settled using money on which tax relief has been granted.
- **LTA utilisation** – when the scheme makes a reduction to your Defined Benefit pension rights because it has paid a tax bill for you, this means that less of your Lifetime Allowance is going to be used up (because your DB pension will now be smaller); if you thought you might be bumping up against the LTA limit, going down the 'scheme pays' route rather than paying the tax bill yourself will give you more headroom for future pension saving.

b) Tax charges for exceeding your Lifetime Allowance

When you come to take benefits, if their total value exceeds the Lifetime Allowance then you will face a charge on the excess. This charge can be applied in a number of ways depending on how the excess money is being taken. The charge is:

- 55% if taken as a lump sum, or
- 25% if taken as income

The liability for paying this charge falls jointly on the scheme administrator and the member affected. The administrator would calculate the capital value of the benefits when they come to be taken and would normally deduct any tax charge before the benefit payment is paid to the member. If the tax charge arises on the death of the member then the charge needs to be paid by the recipient of the fund.

Scheme rules may dictate whether any Lifetime Allowance excess must be taken as a lump sum, an income or a combination of both. It is worth checking these rules first.

The key point is that the individual does not have to find the amount of any Lifetime Allowance charge from their own pocket so there should not be any affordability issues should the allowance be exceeded. Paying the charge from pension benefits also has the benefit of allowing it to be settled from money on which tax relief has been granted.

3. I think I might have to pay a tax charge – should I stop saving into a pension?

It might seem obvious that once you have reached an annual or lifetime limit on tax-privileged pension saving you should stop saving. If you are someone currently at work and a member of a workplace pension scheme, this would imply opting out of your current workplace pension arrangement. But there are a number of reasons why this might not be the right course to take.

These can be quite detailed calculations – especially if both AA and LTA issues are in play – and are best done with the assistance of a qualified adviser, but we deal with the main issues in this section. The central point is that an adviser would be comparing any tax charge you might have to pay if you exceed the AA or LTA with any financial loss (such as a lower pension in retirement) that you would suffer if you were to opt out. In some cases, the conclusion may be that despite paying a tax charge you would still be better off remaining in your pension arrangement.

a) The money my employer puts in

If you are in work and a member of a workplace pension arrangement, your employer will be contributing to your pension. If you opt out, although you save your own contribution and you avoid the risk of a tax charge, you also forfeit your employer's contribution to your pension. In some cases this can be so valuable that it is better to stay in the scheme and pay a tax charge, rather than opt out and lose your employer's contribution.

In a Defined Contribution pension, it is quite common for employers to 'match-fund' the money that an employee puts in to a pension, and more generous employers may even 'double-match'. In the latter case, for every £1 that an employee contributes into a pension, the employer will contribute a further £2. Even if part of the combined pension contribution is in excess of the Annual Allowance and generates a tax charge, the employer contribution is effectively 'free money' and can often exceed any potential tax charge.

Similarly, with Defined Benefit pension arrangements, the cost of the valuable benefits being built up is often being met in significant part through a contribution by the employer. In many public service schemes the employer contribution rate is currently well into double figures. Again, by opting out, the worker may save a tax bill, but loses out on potentially much greater pension benefits.

[5] For higher earners, employers will sometimes offer a cash alternative to those who wish to opt out of their pension scheme because they have exceeded the value of their Annual or Lifetime Allowances.

3. I think I might have to pay a tax charge – should I stop saving into a pension?

b) Benefits for dependants

Up to this point we have looked at the direct financial implications of whether to stay in the scheme and paying the tax charge or opting out. However, there are also wider implications that need to be considered when deciding whether to opt out.

As a member of a pension scheme you are likely to qualify for a number of additional benefits beyond a pension for you when you retire. For example, active members of a pension scheme may qualify for substantial life insurance benefits which would be lost if they were to opt out. Similarly, if you die whilst you are still a member of your pension scheme, your surviving dependants may qualify for a regular pension and the generosity of these arrangement could change if you were no longer actively contributing to the scheme when you died.

c) Other issues to consider

There may be other knock-on effects if you were to decide to opt out of your current pension arrangement and these should all be carefully considered before deciding to stop saving. Some of these areas include:

- *Beneficiary nominations/expression of wishes* – Do scheme arrangements around how death benefits are distributed change if you leave the scheme? This could have an impact on how these benefits are treated when it comes to inheritance tax.
- *Statutory protections* – If you are in a public sector scheme it is worth asking your adviser to check whether opting out of the scheme means you lose any protections – for instance the right to something called 'statutory underpin protection'.
- *Knock on effects on other taxes and benefits* – various elements of the tax system are based on your income after the deduction of pension contributions. If you opt out of pension saving your after-tax income will go up and this might have adverse knock-on effects. For example, those with income above £100,000 have their tax-free personal allowance reduced on a tapered basis. If you are in this income band, a rise in your income (because you have opted out of your pension) could mean that your tax-free personal allowance is reduced. Similarly, couples can face a 'high income child benefit charge' if the higher earner earns more than £50,000 per year. Dropping out of a pension will increase your income when the child benefit charge is worked out and so could increase the amount you have to pay.

CONCLUSION – should I stay or should I go?

When you face the possibility of a tax charge, the decision on whether to remain in a pension scheme or to leave is a complex and individual one. You will need to know how much tax charge you would face if you stayed in the pension arrangement and how much you would lose if you were to opt out. This is a decision that needs to be reviewed on an annual basis, as it might make sense to remain in pensions and pay a tax charge in one year but opt out in another year.

However, the purpose of this guide has been to demonstrate that there is nothing inherently wrong with pension saving beyond tax relief limits. There are advantages to pension saving above and beyond pension tax relief and in some cases these will make staying in your pension scheme the right decision even if you have to pay back some of the tax relief that you have received.

We hope that this guide has also provided some clarity on the annual and lifetime limits on pension tax relief and has helped to demonstrate the importance of being aware of the situations in which you can find yourself affected by those limits.

Ultimately, the decision to stay in or opt out of your pension involves a complex balancing of potential tax implications of staying in against loss of employer contributions and other pension benefits if you were to opt out. For this reason, we are clear that it makes sense to take expert financial advice before making such a decision.

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